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UNCLAS SECTION 01 OF 04 CARACAS 000930

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TREASURY FOR KLINGENSMITH AND NGRANT
COMMERCE FOR 4431/MAC/WH/MCAMERON
NSC FOR DTOMLINSON
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TAGS: EFIN VE
SUBJECT: VENEZUELA'S DEBT PICTURE

REF: A. CARACAS 718
¶B. CARACAS 741
¶C. CARACAS 861

SUMMARY

¶1. (SBU) Venezuela's debt profile is changing, with the BRV financing more domestically and incurring additional debt and liabilities through PDVSA and the Central Bank. External debt as a percentage of GDP remains low (16 percent of GDP) by historical and regional terms; however, "total debt" (external debt, internal debt, Central Bank liabilities, and PDVSA debt) has doubled during the past eight years. Individuals are also becoming increasingly indebted and bank risk profiles are growing -- an unsustainable situation (over the longer term) made possible by the trapped liquidity from windfall oil revenues and government spending. The potential withdrawal from the World Bank and IMF further complicates matters and has increased Venezuela's risk profile by 49 basis points since April 30, thereby making its debt potentially more expensive.

DEBT LEVELS

¶2. (SBU) Since 1998, the BRV has steadily reduced its foreign debt as a percentage of GDP, to the point that it is now below 16 percent of GDP (calculated at the official exchange rate of Bs. 2150/dollar). At the same time, it has been issuing more debt locally, both through bolivar-denominated bonds and certificates of deposit. These instruments have the benefit to the government of being based on the currency it prints (it can print more and pay off the debt with the extra bolivars). The debt table below shows Venezuela's indebtedness since 1998 and over the past five years.

	1998 /	2002	2003	2004	2005	2006
Price of Oil*	10.60	22.20	25.76	32.88	46.03	56.45
GDP Growth	.3	-8.9	-7.7	18.3	10.3	10.3
Foreign	23,314	22,517	24,786	27,471	31,202	25,836

Pct. GDP	25.5	24.2	29.7	24.4	21.8	15.4
Domestic	2,384	11,553	15,029	15,525	15,682	16,851
Pct. GDP	4.9	12.4	18.0	13.8	10.9	9.5
Central Bank	2,863	279	4,720	3,679	14,099	16,162
PDVSA	3,900	6,426	6,265	2,716	2,704	2,476
Total BRV Debt	33,461	40,775	50,800	49,391	63,687	61,325

(The numbers above, with the exception of the price of oil and percentages, are in millions of dollars at the official exchange rate)
*Average price for the Venezuelan oil basket in US dollars

SOURCES: Venezuelan Central Bank, Ministry of Finance, Santander Investment, Embassy Calculations

¶3. (SBU) Venezuela's foreign debt has grown 11 percent (in dollar terms) since 1999, reaching almost USD 26 billion by the end of 2006, a marked decrease from 2005. Much of this decrease was the result of Venezuela's prepayment of Brady bonds, valued at almost USD 4.4 billion, during the year. At the same time, the stock of domestic debt has also grown, from Bs. 2.4 trillion in 1999 (USD 3.7 billion at the then exchange rate) to Bs. 36.2 trillion today (USD 16.8 billion). When adjusted for inflation and devaluation, this represents a 264 percent increase.

¶4. (SBU) Central Bank (BCV) debt/liabilities, while not normally included in calculations of domestic debt, is

nonetheless alarming. As of the end of April, the BCV had Bs. 34 trillion in outstanding notes (USD 15.8 billion), 22 times more than it did in 1999 and 58 times more than in ¶2002. These CDs and structured notes are issued by the BCV to soak up excess liquidity, a relatively recent problem in Venezuela associated with the currency control regime in place since February 2003 and large increases in government expenditures. PDVSA's debt load had actually decreased through the end of 2006, although so far in 2007 PDVSA has issued USD 12.5 billion in debt (reftel B).

¶5. (SBU) If one includes foreign and domestic sovereign debt as well as BCV notes and PDVSA's debt, it paints a grimmer picture for the BRV. Under this methodology, the debt stock almost doubled since 1998 in dollar terms, during a time in which oil prices rose exponentially (from an average of USD 10.60 for the Venezuelan oil basket to USD 56.45) and government revenues similarly surged.

"CHAO" IMF AND WORLD BANK

¶6. (SBU) Minister for People's Power of Finance (MPPF) Rodrigo Cabezas and President Chavez spent several days recently crowing the final payment of Venezuela's World Bank debt. During his April 15 "Alo Presidente" television program, Chavez celebrated that, "sooner rather than later the world will not need them (IMF and World Bank) because they have been the arms of imperialism to dominate the world, to indebt the world, and then enslave it through the perverse mechanism of eternal debt; we are liberated from these chains and these are the steps of the Revolution."

¶7. (SBU) On April 30, Chavez announced that Venezuela would withdraw from the World Bank and IMF (reftel C). This action, if taken, would probably increase Venezuela's debt burden by raising its country risk profile and t@cAQve U.S. Treasuries) has risen by 49 basis points since Chavez' announcement. Over 70

percent of Venezuela's external debt goes into technical default if the country leaves the IMF. While most creditors would probably be willing to accept the technical default as long as Venezuela continues to pay on time, the uncertainty and potential profit from arbitrage between trading and book value of the debt could lead to an expensive rescheduling.

¶8. (SBU) Venezuela still actively engages with the Andean Development Corporation (CAF) and InterAmerican Development Bank (BID), with the CAF recently announcing an increase of USD 600 million in its project portfolio to fund a hydroelectric plant. Venezuela currently has about USD 1.8 billion in outstanding loans with the CAF and approximately USD 1.1 billion with the BID.

OIL PRICES GO UP, DEBT GOES UP?

¶9. (SBU) Venezuela has run a budgetary deficit in seven of the past eight years, though has been issuing more debt than it needs to cover these deficits. Local economists and university professors Miguel Santos and Ricardo Villasmil (PROTECT THROUGHOUT) suspect that this is due to Chavez' preoccupation with maintaining significant levels of contingency, or rainy day funds. (Note: A significant portion of BRV spending is off-budget, and there exists little transparency in how the BRV utilizes off-budget revenues as well. End Note.) Post estimates that the BRV has as much as USD 34 billion non-Central Bank reserves (reftel A). This money serves as an insurance policy for Chavez against a drop in oil prices, potential sanctions, or civil unrest similar to the coup and strikes in 2002-2003.

¶10. (SBU) For Santos and Villasmil, the confluence of the BRV's political and economic policies is notable in the debt service profile. The majority of Venezuela's foreign debt comes due after 2017, and hardly any is due in 2009 or 2012 (election years in Venezuela). This appears to be intentional in order to provide the BRV with the leeway to increase spending during those years to shore up support, as it did in 2006 when government spending (not including

off-budget spending) grew 41 percent (in dollar terms).

Venezuela's Debt Amortization Sechedule (Foreign Debt)

Year	Amount
2007	1,431.81
2008	2,165.56
2009	785.28
2010	2,196.41
2011	2,276.31
2012	580.52
2013	2,037.00
2014	1,812.89
2015	1,494.53
2016	1,628.37
2017-2045	10,805.07

(millions of USD)

SOURCE: Ministry of Finance as of the end of January 2007.

VENEZUELA INDEBTED?

¶11. (SBU) Former head of the Central Bank's Economic Research Division, Jose Guerra recently authored a book entitled, "Venezuela Endeudeada," or Venezuela Indebted. The primary argument of Guerra and many others is that, in a time of historically high oil revenues, it makes no economic sense to be increasing the country's debt burden. While arguments can

be made for issuing debt at rates of interest below the rate of return for an inv!wejzVQQ2i=NQK8y1i_old the proceeds in the bank, or to spend the money on handout programs that do little to boost future growth. (Comment: One could argue, however, that it makes good political sense, given the direction we believe Chavez wants to take the country. End Comment.) Much of the USD 7.5 billion recently issued by PDVSA is expected to go toward current obligations and BRV social spending (reftel B).

¶12. (SBU) Local sovereign debt is issued in bolivars, but at a set exchange rate to the dollar. Thus, should the BRV choose to devalue, its debt burden would remain the same in dollar terms. The preference for local issuances probably stems from the BRV's ability to issue local notes at preferential interest rates (below inflation) as currency controls and excess liquidity result in a seller's market for instruments. For a government little preoccupied with the rule of law or private property rights, local debtors would also be easier to deal with in the event of default or restructuring. Issuing local bonds also allows the government to soak up excess liquidity, one of the primary factors driving Venezuela's double digit inflation and a major preoccupation of Chavez and Minister for People's Power of Planning and Development Giordanni.

¶13. (SBU) The Venezuelan government is not the only institution in Venezuela addicted to debt. Financial institutions have heavily promoted consumer loans and credit cards in recent years, offering interest rates below the rate of inflation and many incentives. The banking system's loan portfolio has grown by 332 percent in dollar terms since 2002, due mostly to the surge in liquidity. Credit cards loans, for example, have grown almost 260 percent. Banks in Venezuela make soi of the highest profits in the hemisphere, with a number of analysts estimating an average above 30 percent (septel). One major bank offers up to six months advance on one's salary and just about any bank will offer a car loan or mortgage with little investigation. While default rates remain low, a cycle of indebtedness is emerging, with borrowers moving from one bank to another, paying off the first credit card with the latter. When liquidity diminishes, this Ponzi scheme will come falling down.

¶14. (SBU) The increasing indebtedness of state institutions, such as the Central Bank and PDVSA is a cause of concern, tempered, however, by the high oil revenues and the ability of the BCV to increase the money supply if its resources

become crimped (however, this would carry an inflationary cost). As a percentage of GDP, Venezuela's foreign debt profile remains very manageable, and some international money managers (to justify their purchases of Venezuelan paper), note that Venezuela has never defaulted. The BRV's foreign debt, as a percentage of GDP compares favorably with other countries in the region, including Argentina (28 percent), Colombia (17), Ecuador (24), and Peru (23). The drop in debt as a percentage of GDP for Venezuela is due mostly to its increase in GDP in recent years, as the total amount in dollar terms has risen slightly since 1999.

COMMENT

¶15. (SBU) While the run up in debt during years of windfall oil revenues does not make much economic sense, for Chavez' revolutionary ambitions it may make perfect sense and be worth the gamble. Recreating a new political, economic and cultural order doesn't come cheap. It is worth remembering that Venezuelan GDP growth is highly dependent on the price of oil and the debt picture only remains manageable so long as oil prices remain high and production doesn't crash. In 2003, when GDP fell 8 percent, Venezuela's foreign debt

burden as a percentage of GDP shot up from 37 percent to 48 percent.

WHITAKER